No. 12539.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

A. BRIGHAM ROSE and ZELLETTA ROSE; LORI, LTD., INCORPORATED; ZELLETTA M. ROSE and A. BRIGHAM ROSE,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition to Review a Decision of the Tax Court of the United States.

PETITIONERS' OPENING BRIEF.

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TOPICAL INDEX

PAGE

TABLE OF AUTHORITIES CITED

STATUTES PAGE

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PETITIONERS' OPENING BRIEF.

Jurisdiction.

The jurisdiction of this Court in this proceeding is based on sections 1141 and 1142 of the Internal Revenue Code. The jurisdiction of the Tax Court was based on section 272 of the Internal Revenue Code.

In T. C. Docket No. 5138, notices of deficiency in income taxes covering the year 1940 were issued to the individual petitioners on March 3, 1944. [R. 11.] On May 31, 1944, said petitioners filed petitions in the Tax Court of the United States for a redetermination of said taxes. [R. 15.] In T. C. Docket Nos. 11737 and 11738 similar notices covering 1938, 1939 and 1941 were issued May 9, 1946 [R. 498, 510]; and petitions therein were

filed in the Tax Court August 7, 1946. [R. 510, 531.] In T. C. Docket No. 5157 notices of deficiency in income, declared value excess-profits, and excess profits, taxes were issued to the corporate petitioner March 7, 1944 [R. 468]; and petition therein was filed in the Tax Court June 2, 1944. [R. 479.]

Because of their factual relation the four T. C. dockets were consolidated for trial. The Tax Court issued a single memorandum findings of fact and opinion on January 6, 1949, and entered its decisions in the several dockets November 21, 1949. [R. 456, 498, 513, 540.] The petition for review by this Court was filed February 17, 1950. [R. 546.]

Statement.

The controversy involves the proper determination of the petitioners' liability for federal income, declared value excess-profits, and excess profits, taxes for the years 1938 to 1941, inclusive.

Lori was organized in 1935. Although it was authorized by its charter to engage in general business activities, it merely held title to certain real estate and carried a bank account, both for the use and benefit of Rose. During the period herein involved Rose was president and treasurer of the said corporation, and owned two of its six issued shares. Rose and his wife came to California in 1927, at which time Rose was admitted to the Bar. Since that time he has engaged in the practice of law in Los Angeles.

The case involves a large number of questions of fact and also certain mixed questions of law and fact. The Commissioner recomputed the income of petitioners on the basis of deposits, and made some allowances of expenses on the basis of checks issued. He also included in the income of Rose all payments made out of the Lori bank account to or on behalf of Rose, and also all payments out of that account not otherwise explained. However, he introduced into evidence certain financial statements submitted by Rose to a bank which, if properly interpreted, completely destroy his computations based upon deposits and disbursements.

The Commissioner also determined that Rose was the beneficial owner of certain property held in the name of Lori; but he taxed the income therefrom to Lori. Further problems arise because of inter-account transfers, deposits resulting from loans, and expenses related to income of Lori paid by Rose out of his personal accounts, but not allowed to Lori by the Commissioner.

The Commissioner failed, moreover, to allow Lori an excess profits credit based upon his own computations of the net income of Lori for 1938 and 1939. The Commissioner also made no allowance for depreciation and imputed to Rose the rental value of property owned and used by him. The Commissioner also charged the petitioners with fraud. With some adjustments the various determinations made by the Commissioner were sustained by the Tax Court.

Specification of Errors.

Petitioners specify the following errors of the Tax Court:

I.

Failure to reduce the amounts added to the gross income of Rose based on total checks drawn by him on the Lori account, by the amounts of Rose's own monies deposited in the Lori account ($10,000, $1,456.76, and $5,805.32 for the years 1939, 1940, and 1941, respectively), and by the amount ($1,200.00) of salary from Lori separately reported by Rose.

II.

Use of financial statements of Rose made on the accrual basis as confirmation of income computed on the basis of deposits and disbursements.

III.

Failure to hold that, Rose being the beneficial owner of the property appearing in Lori's name, any income included in the Lori deposits should be included in the gross income of Rose and not Lori.

IV.

Assuming Lori to be taxable on any income included in the Lori deposits, failure to allow deduction to Lori for related expenses ($10,748.62 for 1938 and $6,107.21 for 1939), paid by Rose out of monies received from Lori.

V.

Failure also to exclude from Lori's income (a) monies borrowed by Rose as an individual and deposited in the Lori account ($3,500.00, $1,456.76, and $3,200.00 for the years 1939, 1940, and 1941, respectively), and (b) monies

transferred from the Rose accounts to the Lori account not representing rentals allocable to the Villa Courts ($1,075.00, $1,500.00, and $1,380.00 for the years 1939, 1940 and 1941, respectively).

VI.

Failure to allow Lori an excess profits credit based on the net income, if any, computed for Lori for 1938 and 1939.

VII.

Inclusion in the gross income of Rose of $900.00 per year as the value of his use of a portion of the Villa Courts.

VIII.

Inclusion in the gross income of Rose for 1938 of his wife's one-half community share of income earned by him.

IX.

Failure to determine the basis of the Silver King Coalition stock sold in 1941 in accordance with the value of the stock when acquired.

X.

Failure to determine any allowance for depreciation on depreciable income properties.

XI.

Attachment of presumption of correctness to the Commissioner's determinations despite the numerous errors in said determinations conceded by the Commissioner and found by the Tax Court.

XII.

Imposition of the 50% fraud penalty on petitioners or any of them.

Summary of Argument.

I.

The Tax Court increased the gross income of Rose by the amounts of $15,873.23, $17,776.63, $8,765.60 and $7,384.12 for the years 1938, 1939, 1940, and 1941, respectively, as representing the *total* payments out of the Lori account to Rose or for his benefit. The Tax Court, however, failed to offset against those amounts monies belonging to Rose as an individual deposited in the Lori account. The evidence shows clearly such deposits in the total amounts of $10,000.00, $1,456.76, and $5,805.32 for the years 1939, 1940, and 1941, respectively. The Tax Court also failed to deduct from said payments to Rose an amount of $1,200.00 reported separately by him as salary received from Lori in 1941. To the extent of the Rose monies deposited in the Lori account, any payments to him were out of his own money. To the extent of the salary item, the inclusion of such payments in his gross income was a mere duplication.

II.

Rose was on a cash basis. The Tax Court accordingly computed his income on the basis of receipts and disbursements, relying on deposits as evidence of income receipts. However, it presented as confirmation of such computation evidence introduced by respondent consisting of financial statements prepared by Rose on the accrual basis and showing large amounts of accounts receivable.

The total net income of Rose and his wife for the four years involved was determined by the Commissioner at approximately $117,000, and by the Tax Court at approximately $79,000. On the returns filed, the total shown was

approximately $37,000. These financial statements relied on by the Commissioner and the Tax Court, when reduced to a cash basis by eliminating the receivables, show a net income for the same period of $41,000. The effect is, then, that they support the petitioners and show that the Tax Court's redeterminations were grossly erroneous.

III.

The Tax Court held that Rose was the beneficial owner of the property appearing in Lori's name. The evidence shows that Lori was a mere title holder of both the property and deposits appearing in its name, and that Rose was the real owner. It necessarily follows that any income included in those deposits was the income of Rose and not Lori.

IV.

The Tax Court computed Lori's income also on the basis of deposits. If any income included in the Lori deposits was Lori income, Lori should be allowed deduction for related expenses. Clearly it is immaterial that such expenses were paid not directly by Lori but by Rose out of monies received from Lori. Rose's bank accounts in that event were a mere conduit. Deduction of such expenses should therefore be allowed to Lori.

V.

(a) Rose borrowed certain amounts as an individual and deposited them in the Lori account. These amounts totaled $3,500.00, $1,456.76, and $3,200.00 for the years 1939, 1940 and 1941, respectively. Obviously these amounts should be excluded from Lori income. They were not the income of Lori, nor were they income at all.

(b) Likewise, Lori deposits included mere transfers from the bank accounts of Rose. Of such transfers $1,075, $1,500, and $1,380 were not excluded by the Tax Court from Lori income. Even if such transfers included income amounts received under a certain lease as contended by respondent in the Tax Court, they were, following the Tax Court's own method of computation, excludible from Lori's gross income because they were not allocable to the Villa Courts. On any basis, therefore, these amounts should be excluded from Lori income.

VI.

The Tax Court made a redetermination of the Lori income for 1938 and 1939. From such income the determination of an excess profits credit is a mere matter of mathematics. The Tax Court should therefore have computed such a credit.

VII.

The Tax Court held that the Villa Courts were beneficially owned by Rose, but it included in Rose's gross income the value of his use of a part of those Courts. It is clear law that a taxpayer is not taxable on the value of his use of his own property. It follows necessarily that the Tax Court erred in this respect.

VIII.

Mrs. Rose is not involved in these proceedings for 1938. Only Mr. Rose is involved. It follows necessarily that Mrs. Rose's community share of Rose's professional earnings for 1938 must be excluded. The Tax Court determined such earnings for 1938 but failed to make such exclusion.

IX.

Rose sold 1200 shares of Silver King Coalition stock in 1941. The Tax Court determined the basis of the

stock from a loan made by Rose on the security of the stock in 1937. However, he acquired the stock as a fee in 1936. Where property is so acquired, the basis is the fair market value when acquired. The Tax Court erred therefore in failing to determine and use such basis.

X.

Petitioners' gross income included building rentals. The Commissioner, however, disallowed the entire amount claimed by petitioners as depreciation. The Tax Court made no allowance for depreciation. It is the duty of the Tax Court to make a determination where it is clear that the Commissioner is wrong, even though the taxpayers' evidence may be unsatisfactory. Therefore, the Tax Court erred in this respect.

XI.

The Commissioner conceded numerous errors before the Tax Court. The Tax Court in its findings shows numerous other errors of the Commissioner. Still other errors of the Commissioner, shown above, did not appear in the Tax Court findings. Where the Commissioner's determinations contain numerous errors, the presumption of correctness which ordinarily attaches to them falls. In this case, therefore, the Tax Court should have placed no reliance upon the Commissioner's determinations and should have made its own independent determinations of the petitioners' income.

XII.

The worst that the evidence shows against the petitioners is gross ignorance and confusion. Not only does it fail to show any deliberate concealment of income; it shows, on the contrary, that the returns filed were substantially correct. Fraud cannot be predicated on confusion and ignorance. The imposition of fraud penalties here is therefore error.

ARGUMENT.

I.

The Additions to the Gross Income of Rose Based on Total Checks Drawn by Him on the Lori Account Should Be Reduced by the Amount of Rose's Own Monies Deposited in the Lori Account.

For each year the Commissioner added to the gross income of Rose an amount labeled "Income From Dividends and/or Gains and Profits from Lori, Ltd., Inc., dends and/or Gains and Profits from Lori, Ltd., Inc.," the amounts for the respective years being as follows: 1938—$15,873.23; 1939—$17,776.63; 1940—$8,765.60; 1941—$7,384.12. [R. 439.]

The detail of the above amounts, as shown in the Commissioner's statutory deficiency notices, is as follows:

1938:	
Payment made to bank by Lori, Ltd., Inc., on your note	$ 2,111.55
Payment made to Harry Blank by Lori, Ltd., Inc., for your account	3,500.00
Payments made to M. Woods by Lori, Ltd., Inc., for your account	10.00
Withdrawals from Lori, Ltd., Inc., retained by you	6,095.00
Checks of Lori, Ltd., Inc., cashed by you and proceeds retained by you	150.00
Checks issued by Lori, Ltd., Inc., to others for your account	722.65
Checks drawn by you as president and treasurer of Lori, Ltd., Inc., and not otherwise accounted for	3,284.03
Total for 1938	$15,873.23

1939:

Withdrawals from Lori, Ltd., Inc., deposited in your bank accounts and not otherwise included as income	$12,299.65
Checks of Lori, Ltd., Inc., cashed and proceeds retained by you	1,854.50
Payment by Lori, Ltd., Inc., on your notes at banks	2,045.66
Payment made by Lori, Ltd., Inc., to others for your account	1,576.82
Total for 1939	$17,776.63

1940:

Withdrawals deposited in your bank account	$ 2,681.90
Other withdrawals received by you	5,054.45
Payment to bank on your note	1,000.00
Payments to others for your account	1,229.25
Total	$ 9,965.60
Less: Salary reported as received from Lori, Ltd., Incorporated	1,200.00
Total for 1940	$ 8,765.60

1941:

Withdrawals from Lori, Ltd., Inc., deposited in your bank accounts	$ 2,616.00
Withdrawals from Lori, Ltd., Inc., and not deposited in bank accounts	18,234.00
Payments by Lori, Ltd., Inc., on your notes at banks	1,701.50
Payments to others by Lori, Ltd., Inc., for your account	1,559.62
Total	$24,111.12
Less: Credit by Commissioner for money of Rose (being an amount received as a fee) deposited in Lori account [R. 442]	16,727.00
Total for 1941	$ 7,384.12

The Tax Court made no change in any of the above items. As it can be seen, there has thus been included in the gross income of Rose all disbursements by Lori to Rose or for his account, including payments on his bank loans; including also all disbursements regarded by the Commissioner as unexplained. [R. 46.] There was only one deduction because of money belonging to Rose which was deposited in the Lori account; that is, the item of $16,727.00 shown above. Obviously, if any amount paid by Lori to Rose or for his account is *ipso facto* treated as income to him, it should be offset by any monies belonging to Rose deposited in the Lori account. This the Commissioner did in respect to the one item of $16,727.00. However, there are numerous other such items shown by the record. Taking only the obvious items and omitting those which are not absolutely clear in the record, there is the following list:

1939

Amount borrowed from bank by Rose as individual and deposited in Lori account September 1, 1939. [Loan shown in Exhibit R, p. D-4, and deposit in Exhibit 12]	$ 2,000.00
Amount borrowed from bank by Rose as individual and deposited in Lori account December 7, 1939. [Note was for $2,000.00, $500.00 thereof being credited on loan account as final payment on principal of preceding note. Exhibit R, p. D-4. Interest of $23.83 on preceding note credited on loan account on same date was paid by counter check dated December 7, 1939. Exhibit 94. The deposit of the net proceeds of the note, $1500.00, appears in Exhibit 12]	1,500.00
Fee of Rose in connection with lawsuit against I.A.T.S.E., the amount thereof deposited in Lori account being [R. 446]	6,500.00
	$10,000.00

1940

Amount borrowed from bank by Rose as individual and deposited in Lori account July 31, 1940. [Note was for $2,000.00, $500.00 and $43.24 thereof being credited on loan account as final payments on principal and interest, respectively, in respect of preceding note. Exhibit R, p. D-5. The deposit of the net proceeds of the new note, $1,456.76, appears in Exhibit 12]	$ 1,456.76
Total for 1940	$ 1,456.76

1941

Amount found by the Tax Court as representing deposit in Lori account of proceeds of personal loan by Rose [R. 446]	$ 2,605.32
Amount borrowed from bank by Rose as individual and deposited in Lori account February 3, 1941. [Loan appears in Exhibit R, p. D-5, and deposit in Exhibit 12]	1,700.00
Amount borrowed from bank by Rose as individual and deposited in Lori account April 21, 1941. [Loan appears in Exhibit R, p. D-5, and deposit in Exhibit 12]	1,500.00
Total for 1941	$ 5,805.32

The Commissioner in arriving at the figure of $8,765.60 which he added to Rose's gross income for 1940 as income derived by Rose from Lori deducted, as it is seen above, an amount of $1200.00 as representing salary from Lori separately reported by Rose. The Commissioner, however, failed to make the same deduction for 1941. That Rose reported such salary separately for 1941 is shown by his return. [Ex. G.]

Summarizing the details shown above, the Commissioner, in arriving at the so-called "Income from Dividends and/or Gains and Profits from Lori, Ltd.," which he added to Rose's gross income, erroneously failed to exclude or offset the following amounts for the respective years:

1939		
Monies belonging to Rose deposited in the Lori account		$10,000.00
1940		
Monies belonging to Rose deposited in the Lori account		1,456.76
1941		
Monies belonging to Rose deposited in the Lori account	$5,805.32	
Salary from Lori separately reported	1,200.00	7,005.32

These errors are obvious and clear on the face of the record. The Tax Court failed to eliminate them. As computation will show, elimination of these obvious errors alone will reduce the 1940 Rose deficiency to $1,041.89, and will convert the Rose deficiencies for 1939 and 1941 into a net overpayment of $25.90.

II.

The Respondent's Own Evidence Based on Financial Statements of Rose Confirm the Correctness of Rose's Returns.

As the Tax Court found, petitioners A. Brigham Rose and Zelletta M. Rose, husband and wife, filed their returns on a cash-calendar year basis. [R. 428.] In arriving at net income on a cash basis, no consideration may be given to accounts receivable or accounts payable; only actual receipts and disbursements may be given effect. *U. S.* v. *Mitchell,* 271 U. S. 9, 46 S. Ct. 418 (1926). Accounts receivable and payable signify the accrual basis. *Spring City Foundry Co. v. Commissioner,* 292 U. S. 182, 54 S. Ct. 644 (1933). These are, of course, simple and self-evident propositions.

Respondent, nevertheless, introduced into evidence in the Court below, as Exhibit S, certain financial statements which petitioner Rose submitted to the Citizens National Bank for the purpose of obtaining credit. As the Tax Court observed, those statements show for the four years herein involved an increase of $75,000 in petitioner Rose's net worth, and income for each of the years herein involved substantially in excess of that reported on his returns. [R. 444.] Apparently, however, the Tax Court failed to examine those financial statements in detail and to observe that they included amounts of accounts receivable and accounts payable. The accounts payable are negligible in amount, but the accounts receivable, while only $6,200 in the statement at the beginning of the four-year period, are $50,000 in the statement at the end of the period. Obviously those statements are on the accrual basis, and obviously also, the major share of the income and of the increase in net worth shown consists of income earned but not received.

The Commissioner introduced those financial statements for the purpose of corroborating his computation of net income based on bank deposits and disbursements. Those very statements, however, when adjusted to the same accounting basis, completely demolish his computation based on bank deposits and disbursements.

Taking the financial statements at the beginning and end of the period, that is the statements for June 11, 1938, and September 21, 1942, adjustment to a cash basis produces the following results:

SCHEDULE OF NET WORTH PER EXHIBIT S
June 11, 1938

	Per Exhibit S	Same Converted to Cash Basis
Cash in Following Banks	None	None
Accounts Due Me—Good	$ 6,200	None
Listed Stocks and Bonds	8,300[1]	$ 8,300
Unlisted Stocks and Bonds	5,000	5,000
Real Estate and Buildings	66,200[2]	66,200
Mortgages and Trust Deeds—2nd Liens	10,500	10,500
Mortgages and Trust Deeds—1st Liens	26,000	26,000
Automobiles and Trucks	500	500
Other Assets (Itemize) personal property	4,500	4,500
Total Assets	$127,200	$121,000
Accounts Payable	$ 300[3]	None
Other Liabilities (Itemize) "Broker on Loan"	4,000	4,000
Mortgages or Liens on Real Estate	12,500	12,500
Total Liabilities	$ 16,800	$ 16,500
Net Worth June 11, 1938	$110,400	$104,500

September 21, 1942

	Per Exhibit S	Same Converted to Cash Basis
Cash in Citizens National Bank	$ 900	$ 900
Accounts Receivable—Good	50,000	None
Listed Stocks and Bonds	23,100	[4]15,600
Unlisted Stocks and Bonds	5,000	5,000
Real Estate and Buildings	64,900	[5]66,200
Other Assets (Detail)		
Equity in Hotel and Villas, etc	40,000	[6]36,500
Personal Property and Auto	None	[7]5,000
Total Assets	$183,900	$129,200
Accounts Payable	$ 100	None
Income Tax Payable	2,800	None
Mortgages or Liens on Real Estate	3,000	3,000
Total Liabilities	$ 5,900	$ 3,000
Net Worth Sept. 21, 1942	$178,000	$126,200

FOOTNOTES TO SCHEDULES

[1]Amount corrected to conform to schedule on back of statement as follows:

SKC	$7,200
SKW	1,000
Ed	100
Total	$8,300

[2]Amount corrected to conform to total of schedule on back of statement.

[3]Labeled "Current" and shown as last item on statement.

[4]Corrected to conform items purchased since June 11, 1938, to cost as follows:

Silver King Coalition	$ 3,600
Silver King Western	1,000
Amer. Tel & Tel.	11,000
Total	$15,600

The Silver King Coalition shares were purchased for $3,600 March 9, 1942, in the name of A. Brigham Rose, through J. A. Hogle & Co., brokers, 532 W. 6th Street, Los Angeles. (These are, of course, not the same shares involved in the loss taken on a sale in 1941.) The Silver King Western stock was on hand June 11, 1938, and appears in the financial statement of that date at the same value. The American Telephone and Telegraph stock was purchased for $11,000 June 30, 1942, in the name of Z. Maud Rose, through J. A. Hogle & Co., brokers, 532 W. 6th Street, Los Angeles. The two purchases are, of course, easily verified by respondent. If the cause is remanded to the Tax Court for a redetermination, evidence on these purchases will be made a part of the record.

[5]Corrected to conform items to June 11, 1938, values, as follows:

1145-1147 No. Vine St.—2 Story Brick, Stores and Apartments	$58,000
8621 Lookout Mountain Drive — 5 room stucco, furnished	4,500
7 Acres Hemet, California	2,700
10 Acres Kings County	1,000
Total	$66,200

Note that this is before any allowance for depreciation for the period 6/11/38 to 9/21/42.

[6]Corrected to June 11, 1938, value of mortgages on same property, from which this item was derived. Note that the value given is only of the equity, not of the property, and that this is before any allowance for depreciation for the period 6/11/38 to 9/21/42.

[7]To include these items because included on June 11, 1938, statement and no evidence they were disposed of during interim.

Computation of Net Income Per Exhibit S.

1. On Basis of Net Worth Data.

Net worth on cash basis Sept. 21, 1942 (see Schedule above)		$126,200
Net worth on cash basis June 11, 1938 (see Schedule above)		104,500
Increase		$ 21,700
Personal expenses for 4-year period:		
Annual personal expenses per June 11, 1938, financial statement (corrected total of items listed)	$ 7,340	
Same per Sept. 21, 1942, financial statement	5,430	
Intervening years, personal expenses not shown on financial statements, amounts estimated for 2 years on basis of average of above amounts (but excluding rent of $1,080 from June 11, 1938, statement for this purpose since Tax Court found he lived in apartment beneficially owned by him)	11,690	
Total for 4 years	$24,460	
Add 1941 income taxes apparently paid before Sept. 21, 1942, (as shown by accrual of balance of $2,800 on financial statement of that date) but not included in itemization of personal expenses	2,800	
Total personal expenses for 4-year period		27,260
Total net income for years 1938 to 1941, inclusive, based on net worth data in Exhibit S, but before any allowance for depreciation		$ 48,960

While the above computation covers A. Brigham and Zelletta M. Rose, it also includes Lori, since Exhibit S shows that Lori was only a title holder. See following wording on September 21, 1942, financial statement under "Other Assets (Detail)":

> "equity in Hotel & Villas—Re Estate—
> 1140-1156 Lillian Way and 6326 Lexington
> Avenue—*in name of Lori Ltd.*" (Italics added)

2. On Basis of Income Data.

Income per Exhibit S (these figures from Exhibit S are given in Memorandum Findings of Fact and Opinion, R. 444):

Date of Financial Statement		Amount
6-11-38		$13,500.00
4-29-39	(In excess of)	10,000.00
3- 1-40	(In excess of)	20,000.00
9-21-42		41,800.00
Total—4 years		$85,300.00

Deduct net increase in accrued income per Exhibit S in order to convert to cash basis:

9-21-42 financial statement		
Accounts Receivable	$50,000.00	
Less Accounts Payable	100.00	$49,900.00
6-11-38 financial statement		
Accounts Receivable	$ 6,200.00	
Less Accounts Payable	300.00	5,900.00
Net increase in accrued income per Exhibit S		44,000.00
Total net income for years 1938 to 1941, inclusive, based on income data in Exhibit S		$41,300.00

Now compare the results shown above with the net income shown by the returns and the net income computations of the Commissioner and the Tax Court, as follows:

		Per Returns	Per Deficiency Notices	Per Tax Court Decisions
1938		None	$ 26,374.72	$ 8,203.21
1939	A. Brigham Rose	$ 3,039.92	17,871.36	10,925.28
	Zelletta M. Rose	3,039.92	17,871.36	10,925.28
1940	Joint return	2,636.57	17,016.40	15,059.99
1941	A. Brigham Rose	14,495.10	18,955.65	17,213.15
	Zelletta M. Rose	14,495.10	18,955.65	17,213.15
	Total	$37,706.61	$117,045.14	$79,540.06

To adjust basis of assets to Exhibit S:			
Add back loss on stock deducted in 1941	2,773.50	2,773.50	2,773.50
	$40,480.11	$119,818.64	$82,313.56
Deduct:			
Value of stock per Exhibit S (financial statement June 11, 1938) $7,200.00			
Net selling price 4,053.00	3,147.00	3,147.00	3,147.00
Total net income for years 1938 to 1941, inclusive, with basis of assets adjusted to Exhibit S	$37,333.11	$116,671.64	$79,166.56

Now observe the effect of this comparison. Respondent's Exhibit S, adjusted to a cash basis, shows the net income of Rose and his wife for the four-year period at $49,000.00 approximately, before any allowance for depreciation, on the basis of net worth data, and at $41,000.00 approximately on the basis of income data. On their returns petitioners reported income totaling approximately $37,000.00. However, the Commissioner on the basis of deposits and disbursements arrived at a figure of $117,000.00, and the Tax Court at a total of $79,000.00. Hence, Exhibit S, which the Commissioner intended as corroboration for his computation based on deposits and disbursements, only makes those computations appear absurd and confirms the truth and accuracy of petitioners' returns.

It follows by the Commissioner's own evidence that the petitioners' returns were correct, or fairly so. If there were erroneous omissions from income, substantially similar amounts must erroneously have been included in income, or omitted from deductions.

III.

Lori Being a Mere Title Holder for or Agent of Rose in Respect to the Property and Funds Appearing in Its Name, Any Income Included in the Lori Deposits Should Be Included in the Gross Income of Rose and Not Lori.

The Tax Court found that while Lori was authorized by its charter to engage in general business activities it "did engage in the business of holding real estate." [R. 428.] Nowhere in the record is there any indication that Lori engaged in anything else. It held title to the Villa Courts. [R. 433.] Nowhere does it appear that it held title to any other property. Even as to that one property, it was a mere title holder; for, as the Tax Court found, those courts *"were beneficially owned by Rose,* subject to the encumbrances against them and the unliquidated claim of Mary Woods *against Rose";* and by his expenditures on behalf of Lori, Rose "sought to and did thereby protect and preserve *his*" equity in the property. [R. 433, 441—Italics supplied.] Furthermore, on the financial statement of petitioner Rose, dated September 21, 1942, included in Respondent's Exhibit S, there is, as already observed, the following explanation of the item "Other Assets":

> "equity in Hotel and *Villas*—Re Estate—1140-1156 Lillian Way and 6326 Lexington Avenue—*in name* of Lori, Ltd." (Italics added.)

The only other thing which appeared in Lori's name was a bank account. As to that, the Tax Court found that it was used by Rose for his "personal deposits and expenditures." [R. 431.] The Tax Court further found that the Lori bank account was "used during the years in question as a depository of substantial sums, in which

it had no interest, including receipts from petitioner's law business and sums reflecting receipts from the hotel operations." [R. 447.] As to the receipts from the Villa Courts, when respondent's witness, Silvester Rocco, was asked on direct examination "just what function Lori served in this picture, that is, what activity it carried on in respect of these villas," he answered: "The only activity I could determine was to receive cash—that I could determine—and allow Mr. Rose to withdraw it." [R. 70.]

On direct examination, Rocco was also asked whether Lori "was authorized to carry on various activities in addition to holding this property." [R. 70.] Why he was asked that question, it is not clear, except possibly as a substitute for a showing that there were in fact any activities. When the same witness, however, was asked what expenses Lori had, he admitted that he had allowed as expenses only $44.85 for the year 1938. [R. 70-71.] One can well imagine what activities a corporation could engage in on $44.85 for an entire year. The Tax Court itself was perplexed by this fact. Note the Court's statement [R. 72]:

> "Rather quaint way to do business, to have a corporation with gross income of around $25,000.00 and no appreciable expenses, and fail to pay its taxes."

Nor was all this merely a result of control resulting from ownership of stock. The Tax Court found that of

> "the six issued shares of stock of Lori, two were held by petitioner, two were issued in the name of Paul Angelillo, who was its vice-president, and was also an attorney associated with petitioner, maintaining his office at the same address, and the remaining two shares were issued in the name of P. M. Woods, the stepfather of Mary Allen, who was a client of petitioner." [R. 428-429.]

The proper and only conclusion is that Lori was a mere agent or title holder and had no beneficial interest in the property which stood in its name or in the funds which were received and disbursed in its name.

Where a corporation is simply the agent, fiduciary or *alter ego* of another person, or merely the conduit of funds of another person, that corporation must be disregarded as a separate taxable entity. Such is the clear effect of this Court's decision in *Seattle Hardware Company v. Squire,* 181 F. 2d 188 (1950). The same rule was stated by the Eighth Circuit in *Keokuk & Hamilton Bridge, Inc. v. Commissioner,* 180 F. 2d 58 (1950).

The latter case cites pertinent decisions of the Supreme Court. Thus, as there quoted, in *Commissioner v. Wilcox,* 327 U. S. 404, 66 S. Ct. 546 (1946), the Supreme Court stated as one of the conditions of taxable gain that there be present a "claim of right to the alleged gain." Again, in *Griffiths v. Commissioner,* 308 U. S. 355, 60 S. Ct. 277 (1940), the Supreme Court stated, 308 U. S. at page 357:

> "We cannot too often reiterate that 'taxation is not so much concerned with requirements of title as it is with actual command over the property taxed—the *actual benefit* for which the tax is paid.' " (Italics added.)

It must follow from the cases above cited that Lori is not a separate taxable entity and that no tax should have been imposed upon it. If any income was received in the name of Lori, it should be taxed to Rose.

IV.

Assuming Lori to Be Taxable on Any Income Included in the Lori Deposits, Lori Should Be Allowed Deduction for Related Expenses Paid by Rose Out of Monies Received From Lori.

In its findings, the Tax Court made the following allowances to Rose under the title of "Current operating expenses of Lori and Hotel paid from bank accounts of Rose" [R. 441]:

1938	$10,748.62
1939	6,107.21

The above items are apparently totals of the following:

1938

Exhibit	R.		Amount
15	144–148	Employee wages	$ 6,209.73
16	148	Utilities	1,552.43
17	149	H. Wall advertising on hotel	425.00
18	149	R. E. taxes on hotel	1,595.95
19	149	R. E. taxes on Lori apts.	508.65*
20	150	Street bond assessment	40.09
21	150–152	1937 taxes paid in 1938	263.27
23	153	Repairs	53.50
48	169–170	Plastering	100.00
			$10,748.62

1939

Exhibit	R.		Amount
58	197	Hotel repairs—Labor & Material	$ 485.47*
68	201	Misc. Expense on hotel	2,928.20
69	201–202	Interest paid on mortgage loans, Hotel Angie	940.00
86	208–209	Real estate taxes paid	1,753.54
			$ 6,107.21

*Amount per Exhibit in each case.

In reference to the above amounts, the Tax Court stated [R. 441], that:

> "The expenditures made by Rose on behalf of Lori and the hotel operations were out of funds received by Rose from Lori. Lori, in turn, received gross sums from Brevoort Enterprises covering both the hotel and Villa Court operations. By these expenditures petitioner sought to and did thereby protect and preserve his equities in the various properties, the operations of which inured to his benefit."

In other words, Lori received monies in respect of the hotel and Villa Court operations from Brevoort Enterprises, and paid them out through Rose for hotel and Villa Court expenses. Clearly if these items had been paid directly by Lori, no question could be raised as to their deductibility to Lori. The Tax Court computed Lori's gross income on the basis of Lori deposits, which included both hotel and Villa Court receipts; and these expense items were hotel and Villa Court expenses.

There appears to be no reason why these expense items should not be allowed merely because the payments were made through the bank accounts of Rose. Where one person pays the expenses of another, those expenses are constructively paid by the other as if he had himself made the payments.

> *Minnesota Tea Company v. Helvering,* 302 U. S. 609, 58 S. Ct. 393 (1938).

In the case cited, the Supreme Court stated, 302 U. S. at page 613:

> "The conclusion is inescapable, as the court below very clearly pointed out, that by this roundabout process, petitioner received the same benefit 'as

though it had retained that amount from distribution and applied it to the payment of such indebtedness.'"

To the same effect,

U. S. v. Boston & Maine Railroad, 279 U. S. 732, 49 S. Ct. 505 (1929).

It follows clearly that the total of $10,748.62 should be allowed as an additional deduction to Lori for 1938, and the total of $6,107.21 as an additional deduction to Lori for 1939.

V.

There Should Also Be Excluded From Lori's Income (a) Monies Borrowed by Rose as an Individual and Deposited in the Lori Account, and (b) Monies Transferred From the Rose Accounts to the Lori Account Not Representing Rentals Allocable to the Villa Courts.

As the Tax Court found, Lori's bank account was used during the years in question as a depository of substantial sums in which it had no interest. [R. 447.] The Tax Court, in fact, excluded from Lori income certain deposits in the Lori bank account which were not income, or were not income of Lori. [R. 446.] There are many others of the same character which it failed to exclude.

(a) Such other items which should be excluded from the income of Lori include Lori deposits resulting from bank loans made by petitioner Rose, as follows:

Date	Amount
September 1, 1939	$2,000.00
December 7, 1939	1,500.00
July 31, 1940	1,456.76
February 3, 1941	1,700.00
April 21, 1941	1,500.00

These same loans appear under point I above. Citation to the record and explanatory notes are given there. Since the determination of the net income of Lori was made by the Tax Court on the basis of deposits, it is obvious that the above deposits should have been excluded.

(b) Such other items which should be excluded from the income of Lori include also monies transferred from the Rose accounts to the Lori account not representing rentals allocable to the Villa Courts.

The Tax Court in its findings presents what it states is petitioners' analysis of Lori's bank deposits. [R. 446-447.] Included in that analysis and not presented in said findings, however, are the following transfers from the Rose accounts to the Lori account:

Date	Exhibit	Amount	Total for Year
October 7, 1938	26	$1,100.00	$1,100.00
October 17, 1939	71	$1,075.00	$1,075.00
October 30, 1940	91	$ 500.00	
December 18, 1940	91	1,000.00	$1,500.00
August 1, 1941	91	$ 80.00	
March 19, 1941	91	900.00	
February 18, 1941	91	400.00	$1,380.00

As to 1938, respondent conceded that the amount of $1,100.00 should be excluded from Lori income and the Tax Court so excluded it. [R. 446.] As to the other

years, however, respondent contended in his brief in the Tax Court, pp. 47, 60, that the amounts should not be excluded from Lori's income because they represented additional receipts under a lease to one F. A. Linck, which lease covered in part the Villa Courts held in Lori's name. [That lease is explained by the Tax Court at R. 435.]

Now the Tax Court allowed exclusion from Lori income of the excess of the receipts under that lease over the amounts allocable to the Villa Courts. The amounts so excluded are as follows:

1939	(This amount is included in a total of $8,966.51. See Exhibit FF and R. 446)	$3,316.51
1940	R. 447	4,130.92
1941	R. 447	3,955.00

These amounts were computed by the Tax Court by deducting the receipts under the Linck lease allocable to the Villa Courts from the amounts shown by petitioner's analysis as total receipts under the Linck lease included in the Lori deposits.

For example, for 1940 such total receipts were $8,930.92 [R. 447], which less the amount excluded of $4,130.92, shown above, equals $4,800.00, or one-third of $1,200.00 per month, which was the rental allocable to the Villa Courts. [R. 435-436.] For 1941 the corresponding computation is $8,355.00 [R. 447], less $3,955.00 shown above, or $4,400.00, the amount allocable to the Villa Courts. (Actually the figure for 1940 should also have been $4,400.00, instead of $4,800.00, since $100.00 per month was abated on the rent, leaving the net rental at

$1,100.00 per month [R. 435]; and the amount excluded for 1940 should therefore have been $4,530.92 instead of $4,130.92.)

It follows that the amounts of $1,075.00, $1,500.00 and $1,380.00, representing transfers from the Rose accounts to the Lori account for the years 1939, 1940 and 1941, respectively, were not considered by the Tax Court in arriving at the receipts under the Linck lease when it computed the amounts to be excluded from Lori income because not allocable to the Villa Courts. Yet it is clear that these amounts of $1,075, $1,500 and $1,380, if not excludible simply as transfers from the Rose accounts, which they were, should, as respondent contended in his brief in the Tax Court, have been added to the receipts under the Linck lease included in the Lori deposits. When so added, they increase *pro tanto* the amounts of such receipts excludible from Lori income because not allocable to the Villa Courts. Either as mere transfers from the Rose accounts, therefore, or as receipts under the Linck lease, these amounts should be excluded from Lori income.

Petitioners do not concede that the items described under (a) and (b) above are the only other items which should be excluded from the Lori income. These are merely the items which appear clear on the face of the record.

VI.

An Excess Profits Credit Should Be Allowed Lori Based on the Net Income, if Any, Computed for Lori for 1938 and 1939.

Sections 713 and 714 of the Internal Revenue Code provided the methods for determining the amount of normal earnings of a taxpayer the excess over which was made subject to the excess profits tax. Section 713 provided the income method, under which such normal earnings were based on the average income for the years 1936 to 1939, inclusive. Those years were called the "base period," and the average income of those years was called the "average base period net income." The final figure to be used, the "excess profits credit," was 95% of the "average base period net income," plus specified adjustments.

Under 713(f) this income method was given a variation generally known as the "growth formula." Under that formula, if the average annual income of the second half of the base period, that is, the years 1938 and 1939, exceeded the average annual income of the first half of the base period, that is, the years 1936 and 1937, then the figure to be used as average base period net income was the average of the second half of the base period, plus one-half of the increase of the annual average of the second over that of the first, with a limitation to the highest year in the base period.

It is obvious from this formula that it is mathematically impossible for the excess profits credit to be less than 95% of the average income of the second half of the base period, that is, the average of the years 1938 and 1939. The net income for those two years as determined by the

Tax Court was $9,488.13 and $8,167.24, respectively, so that said average net income was $8,827.68.

Where a result follows mathematically it must be given effect in a recomputation of taxes, even though no issue respecting that result is raised in the pleadings. (*Zimmerman v. Commissioner,* 36 B. T. A. 618 (1937).) The Board there stated, at page 620:

> "In other words, in view of the law as it was at the time of filing of the petitions herein, the issue of the reduction of the charitable gifts bases was a matter petitioners should have foreseen to be necessarily involved in the arithmetical calculations incident to a recomputation along the lines of their contentions in the petitions filed herein."

It is true that in arriving at the "average base period net income" the income used for each year in the base period is the "excess profits net income," which is the net income plus or minus certain adjustments, mostly elimination of abnormal deductions. (I. R. C. Sec. 711(b).) It is true also that there is no finding by the Tax Court here with respect to the excess profits net income of either 1938 or 1939. However, the adjustments from net income to excess profits net income are mostly plus adjustments, the elimination of abnormal deductions. The only minus adjustments are for dividends received, capital gains, and income from retirement or discharge of bonds. (I. R. C., Secs. 711(b) (1) (B), (C), (G).) There is nothing in the findings, nor anything anywhere in the record, to give the slightest suggestion that any such income might exist here. The only type of income referred to in respect to Lori is rentals. In any event, if such a

finding was necessary, it was the duty of the Tax Court to make it. (*Helvering v. Taylor,* 293 U. S. 507, 55 S. Ct. 287 (1935).)

If an excess profits credit is allowed here equal to the average net income of 1938 and 1939, as the net income of those years is computed by the Tax Court, there is, as computation will show, no excess profits tax liability.

VII.

Rose Being Found to Be the Beneficial Owner of the Villa Courts, the Value of His Use of a Portion of Said Property Should Not Be Included in His Gross Income.

Since the Tax Court treated Rose as the beneficial owner of the Villa Courts, there is no basis upon which there can be included in the income of Rose the amount of $900.00 per year as the rental value of the part of that property occupied by him. That amount was included each year in the statutory notices. [R. 439.]

An owner of property, or one who has the beneficial interest in property, is not taxable under the income tax on the value of the use of the property. (*Commissioner v. Plant* (C. C. A. 2), 76 F. 2d 8 (1935).) The Court of Appeals for the Second Circuit there stated, at page 10:

> "It is apparent from the foregoing that the case is like one of a trust under which the trustee is directed to keep a house in repair and allow a beneficiary to live in it rent free. The advantage derived by a beneficiary under such a trust is not taxable as part of his income."

It must follow that these amounts of $900.00 per year are not includible in Rose's gross income.

VIII.

Rose's Income All Being Community Property, the Community One-half Share of His Wife for 1938 Should Be Excluded From His Separate Return for That Year.

The findings show that petitioner Rose and his wife were husband and wife domiciled in the State of California. [R. 428.] They came to California in 1927, at which time Rose was admitted to the Bar and commenced to practice law. Since that time he has been engaged in the practice of that profession in Los Angeles. [R. 429.]

Petitioner Rose's property interests began in 1931 [R. 431.] In any event, his professional income, it is clear, was community income.

The Commissioner's deficiency notice shows Rose's professional income for 1938 to be $8,172.55. [R. 438.] The Tax Court does not indicate that it made any change in that amount. The Tax Court, however, failed to exclude one-half of that amount or any part of it from the income of Rose as being instead the community share of his wife.

There is no finding that Rose filed a joint return for 1938. On the contrary, it appears clear from the Tax Court's findings that no such return was filed. [R. 429.] The deficiency notice for 1938 was addressed to A. Brigham Rose only. [R. 525.] In respect to that year, the petition filed in the Tax Court, Docket 11,738, shows the name of A. Brigham Rose only. The statutory deficiency notice issued to Mrs. Rose does not show 1938 [R. 506], nor, of course, does the petition filed by her in the Tax Court, Docket 11,737. [R. 498.]

It is clear then that as far as 1938 is concerned, Mrs. Zelletta M. Rose is not involved in these proceedings at all. Her income for that year must therefore be excluded. The Tax Court clearly erred in that respect.

IX.

The Basis of the Silver King Coalition Stock Acquired by Rose as a Fee and Sold by Him in 1941 Should Be the Value Thereof When Acquired.

In 1941, Rose sold 1200 shares of Silver King Coalition stock. Rose reported a loss on the sale based upon a figure of $9,600.00 as the cost of the stock. Respondent cut the basis down to $4,500.00, alleging that that was cost of the stock and that it was acquired by petitioner November 18, 1937, at that figure. [R. 529-530.] The Tax Court sustained the Commissioner, merely saying:

> "Respondent allowed as a basis for this stock the amount of $4,500.00, the maximum allowable therefore at the date of acquisition." [R. 443.]

The record is clear, however, that the figure of $4,500.00 was only the amount of a loan which petitioner made against the stock in 1937 at the brokerage house of Hogle & Co. [R. 298.] The stock was actually acquired as a fee in 1936. [R. 298.] The basis of the stock was therefore the value of the stock when petitioner acquired it. (*Helvering v. Salvage,* 297 U. S. 106, 56 S. Ct. 375 (1936).)

In the *Salvage* case, stock was purchased in 1922 at $100.00 per share, although its market value at the date of acquisition was $1,164.70. The difference was consideration for an agreement not to compete and for other covenants. The taxpayer sold the stock in 1929. The Supreme Court held that the basis for computing gain or loss on the sale was $1,164.70. It also held that the failure to disclose the difference between the amount paid and market value in 1922 as taxable gain apparently resulted from an innocent mistake of law, and that there was nothing therefore to support a claim of estoppel.

If the respondent did not agree that the figure of $9,600.00 was the correct value of the Silver King Coalition stock when petitioner acquired it, he should have substituted another figure based upon a valuation at the time petitioner acquired it, and not upon an amount which petitioner borrowed on the stock in the following year. Furthermore, upon this state of the facts, it was the duty of the Tax Court to make such a valuation and not merely to adopt respondent's determination. (*Helvering v. Taylor, supra.*) The Tax Court questioned petitioner Rose at length in regard to that stock. [R. 297-301.] At no time, however, did it ask the question essential to a determination of basis, that is, under the circumstances as stated, what was the value of the stock when Rose acquired it, or what evidence he had, if any, of its value when he acquired it. The Tax Court erred in failing to make such a determination.

X.

Petitioners Must Be Allowed Depreciation on Depreciable Income Properties.

The Commissioner disallowed completely the deductions which Lori took for depreciation. [R. 473, 475, 477.] The Tax Court sustained these disallowances. Neither the Commissioner nor the Tax Court allowed any depreciation to the individual petitioners.

Rentals from buildings owned by petitioners were included in gross income. [R. 435.] Some allowance must therefore be made for depreciation. (Revenue Act of 1938, Sec. 23(l); Internal Revenue Code, Sec. 23(l).)

Under the circumstances, even if the petitioners' evidence was unsatisfactory, it was the duty of the Tax Court to determine an allowance for depreciation.

Harvey v. Commissioner (C. C. A. 9), 171 F. 2d 952 (1949);

Haden v. Commissioner (C. C. A. 5), 165 F. 2d 588 (1948);

Cohan v. Commissioner (C. C. A. 2), 39 F. 2d 540 (1930).

XI.

Because of the Numerous Errors Conceded and Found in the Commissioner's Deficiency Determinations, No Presumption of Correctness Should Be Attached to Them.

The presumption of correctness which ordinarily attaches to the Commissioner's deficiency notices has been overcome by the gross errors in said notices conceded by the Commissioner [R. 440-446], the numerous errors therein found by the Tax Court [R. 441, 447], and the

errors pointed out herein which the Tax Court should also have found.

Helvering v. Taylor, supra;

Clinton Cotton Mills, Inc. v. Commissioner (C. C. A. 4), 78 F. 2d 292 (1935);

Russell v. Commissioner (C. C. A. 1), 45 F. 2d 100 (1930);

Federal National Bank of Shawnee v. Commissioner (C. C. A. 10), 180 F. 2d 494 (1950).

In the *Russell* case, the Court of Appeals for the First Circuit, stated, at page 103:

> "While there is a presumption that the commissioner's findings are correct (*Avery v. Commissioner,* 22 Fed. (2d) 6), when it appears, as in this record it does appear, that the methods pursued by the commissioner were mathematically and legally erroneous, that presumption no longer avails. *New York Life Ins. Co. v. Ross,* 30 Fed. (2d) 80, 82."

In the *Taylor* case the Supreme Court stated, 293 U. S. at p. 515:

> "But, where as in this case the taxpayer's evidence shows the commissioner's determination to be arbitrary and excessive it may not reasonably be held that he is bound to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount that lawfully might be charged against him. On the facts shown by the taxpayer in this case, the board should have held the

apportionment arbitrary and the commissioner's determination invalid. Then, upon appropriate application that further hearing be had, it should have heard evidence to show whether a fair apportionment might be made and, if so, the correct amount of the tax."

On February 7, 1949, petitioners filed in the Tax Court a motion for rehearing. [R. 4.] In that motion, which was the first time undersigned counsel entered this case [R. 4], petitioners pointed out some of the obvious errors shown above in this brief. That motion for rehearing was denied May 5, 1949. [R. 4.] On June 8, 1949, petitioners filed a second motion for rehearing and supported it with a full statement of objections to the respondent's computation under Rule 50. In that statement they pointed out most of the errors shown above in the Tax Court's findings and opinion. On the same date they also filed a motion to set the said motion for rehearing on the calendar in Los Angeles for oral argument. These motions, however, were denied. [R. 5.]

Petitioners therefore made the "appropriate application that further hearing be had," referred to by the Supreme Court in the *Taylor* case. The Tax Court should have granted such a hearing here, should have disregarded the Commissioner's deficiency determinations, and should have made an independent redetermination of the net income of petitioners.

XII.

Petitioners' Gross Ignorance of Accounting and Income Tax Matters Cannot Be Made a Basis of Fraud.

As the statute reads, I. R. C., Sec. 293(b), a 50% penalty applies where "any part of any deficiency is due to fraud with intent to evade tax." The Tax Court determined that the petitioners were subject to that penalty. The Tax Court should have determined, on the contrary, that the Commissioner was guilty of negligence in failing to recognize and act upon the confused and stunted character of petitioner Rose's knowledge of accounting and business.

Rose, it is true, was an attorney. Petitioners ask this Court. however, to take judicial notice of the fact that prior to the most recent years accounting was not a prerequisite to nor a part of a course in law, nor was any knowledge of income taxes a prerequisite to or a part of a course in law; nor were any questions relating to these subjects contained in any Bar examination, including that of the State of California. A total lack of knowledge of accounting, income taxes and all practical aspects of business operation was wholly consistent with admission to the Bar and even success in many fields of that profession.

The Tax Court's own findings should have informed it that it had on its hands one who was a helpless infant in accounting and income tax matters. As the record shows, petitioner A. Brigham Rose was the sole attorney in this proceeding until February 7, 1949, when a motion

for rehearing was filed in the Tax Court. [R. 4.] No rehearing was granted. [R. 4, 5.] As the Tax Court found, petitioner Rose filed for the year 1938 a very strange return. It read as follows [R. 429]:

> "From various interests and personally, have handled sum greatly in excess of $5,000.00 for the taxable year of 1938, but have expended and borrowed a sum in excess of the amount handled, but unfortunately, the records requisite to rely on for details are not available to me for diverse reasons. I am, therefore, making this return: That I Owe Nothing, and will supplement this Income Tax Return on request."

For the same year, Lori filed a return over the signature of petitioner Rose which merely recited the following [R. 448]:

> "This corporation has gone into debt for the year 1938 and made no profits."

It is thus obvious that Rose did not know the difference between income and receipts, or between expenses and disbursements, or between expenses and obligations. The Commissioner, as well as the Tax Court, was fully aware of that situation. Silvester Rocco was the revenue agent who investigated Rose's returns. [R. 34.] Here is a part of his testimony on cross-examination by Rose [R. 403]:

> "Q. You never asked me about that I.A.T.S.E. fee? A. Mr. Rose, I asked you about—one time about that I.A.T.S.E. fee, and asked if you reported it. You very definitely told me you did not consider that to be income to be reported, because you had paid off your mortgage to save your property with that."

Rocco answered further, in regard to the same fee [R. 404]:

> "you were amazed to think I would ask you about that."

The Tax Court summed it all up very aptly in its opinion as follows [R. 450]:

> "Petitioner's principal contention, which is totally lacking in merit, is that since most of the monies received were paid out in one way or another, without regard to the nature of the expenditures so far as tax deductions are concerned, that taxable income was no greater than that reported."

Call that what you will, it is the very antithesis of fraud. Nowhere is there any evidence of the "elaborate artifice" which the Tax Court itself indicated as one of the elements of fraud. [R. 451.] In respect to accounting and income taxes, the condition or status of petitioner Rose may be described as abysmal ignorance, naiveté, or puerility. Clearly it was not fraud.

In *John B. Arnold v. Commissioner,* 14 B. T. A. 954, appeal dismissed, C. C. A. 8, 38 F. 2d 1011 (1930), the taxpayer was also an attorney. There the Board stated, at page 974:

> "The system of accounting existing in the offices of the Arnolds at the time the fees began to come in was hopelessly inadequate, and to this inadequacy is to be charged a great portion of the confusion which has resulted. Because the Arnolds did not appreciate the necessity and importance of an adequate system of accounts, no thoroughgoing revision of the system was undertaken and an inadequate personnel was retained to maintain such accounts as were kept. There is, however, nothing to indicate that inadequate

records were maintained to the end that the amount of gross income actually derived be concealed."

Again, in *Rickard v. Commissioner,* 15 B. T. A. 316 (1929), the Board stated, at page 317:

> "Rickard kept no personal books, but believing that he would be obliged to incur legal expenses and possibly be required to pay fines as a result of the indictments which would equal the amount in his hands as profits of the motion picture venture, he did not return as income for 1921 the profits so received.
>
> . . . . . .
>
> "Rickard's belief that he would be called on to pay lawyer's fees and fines constituted no valid reason for failure to report as income the profits so received. The expenditure had not been incurred and even if already expended such items would not have been deductible expenses.
>
> . . . . . .
>
> "We do not agree, however, with respondent's finding that Rickard was guilty of fraud with intent to evade tax. Since this case was heard after the Revenue Act of 1928 became effective, the burden of establishing fraud was on respondent. To establish fraud the production of clear and convincing evidence is necessary. The evidence fails to sustain the charge. Rickard acted ignorantly but without intent to defraud."

Here there was confusion and inadequacy of records, and there was ignorance, gross and palpable ignorance. But such facts do not make a case of fraud.

Moreover, despite Rose's ignorance in respect to accounting and income tax matters, his determinations of

net income represented substantial truth. The Tax Court rested its conclusion of fraud largely on certain financial statements submitted by petitioner Rose to the Citizens National Bank. [R. 444, 450-451.] It even went so far as to point out [R. 451] that the falsification of such statements is a crime under California law. Yet these very statements when properly interpreted, that is, adjusted from the accrual to the cash basis as we have heretofore in this brief, under Point II, instead of revealing any substantial understatement of income in petitioner's returns, in fact corroborate the correctness of the returns. As shown under Point II for the four years involved herein, the Commissioner determined the net income of petitioners Rose and his wife to total approximately $117,000. The Tax Court reduced that total to approximately $79,000. Apparently the Tax Court thought it had confirmation of that total in the net worth increase of $75,000 shown by the financial statements referred to; also in the total income of $85,000 shown in those financial statements for the four years. However, as also shown under Point II, when adjusted to a cash basis that total of income telescopes down to $41,000. Assuming that figure to be correct, the total income shown in the petitioners' returns for those years represents a deviation from the correct figure of only $4,000. Compared with the deviation of the Commissioner's figure, and of that found by the Tax Court, this deviation of $4,000 could hardly be called error. Clearly it is not the work of one bent on fraud.

Conclusion.

Petitioners contend, in conclusion, that the Tax Court erred in each and all of the above respects; and that the decisions of the Tax Court should be reversed, with remand, if this Court deems necessary, in respect to any factual issues which must be resolved.

Respectfully submitted

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Attorney for Petitioners.

APPENDIX.

Provisions of Internal Revenue Code.

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * * * *

(1) DEPRECIATION.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.

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(b) FRAUD.—If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3176 of the Revised Statutes, as amended.

SEC. 711. EXCESS PROFITS NET INCOME.

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(b) TAXABLE YEARS IN BASE PERIOD.—

(1) GENERAL RULE AND ADJUSTMENTS.—The excess profits net income for any taxable year subject to the Revenue Act of 1936 shall be the normal-tax net income, as defined in section 13(a) of such Act; and for any other taxable year beginning after December 31, 1937, and before January 1, 1940, shall be the special-class net income, as defined in section 14(a) of the applicable revenue law. In either case the following adjustments shall be made (for additional adjustments in case of certain reorganizations, see section 742(e)):

(A) Income Taxes.—The deduction for taxes shall be increased by an amount equal to the tax (not including the tax under section 102) for such taxable year under Title I or Chapter 1, as the case may be, of the revenue law applicable to such year [applicable to 1940 only];

(B) Long-Term Gains and Losses.—There shall be excluded long-term capital gains and losses. There shall be excluded the excess of gains from the sale or exchange of property held for more than eighteen months which is of a character which is subject to the allowance for depreciation provided in section 23(l) over the losses from the sale or exchange of such property;

(C) Income From Retirement or Discharge of Bonds, and So Forth.—There shall be excluded, in the case of any taxpayer, income derived from the retirement or discharge by the taxpayer of any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than eighteen months, including, in case the issuance was at a

premium, the amount includible in income for such year solely because of such retirement or discharge;

(D) Deductions on Account of Retirement or Discharge of Bonds, and So Forth.—If during the taxable year the taxpayer retires or discharges any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than eighteen months, the following deductions for such taxable year shall not be allowed:

(i) The deduction allowable under section 23(a) for expenses paid or incurred in connection with such retirement or discharge;

(ii) The deduction for losses allowable by reason of such retirement or discharge; and

(iii) In case the issuance was at a discount, the amount deductible for such year solely because of such retirement or discharge;

(E) Casualty, Demolition, and Similar Losses.—Deductions under section 23(f) for losses arising from fires, storms, shipwreck, or other casualty, or from theft, or arising from the demolition, abandonment, or loss of useful value of property, not compensated for by insurance or otherwise, shall not be allowed;

(F) Repayment of Processing Tax to Vendees.—The deduction under section 23(a), for any taxable year, for expenses shall be decreased by an amount which bears the same ratio to the amount deductible on account of any repayment or credit by the corporation to its vendee of any amount attributable to any tax under the Agricultural Adjustment Act of 1933, as amended, as the excess of the aggregate of the amounts so deductible in the base period over the aggregate of the amounts attributable to taxes

under such Act collected from its vendees which were includible in the corporation's gross income in the base period and which were not paid, bears to the aggregate of the amounts so deductible in the base period;

(G) Dividends Received.—The credit for dividends received shall apply, without limitation, to dividends on stock of domestic corporations;

(H) Payment of Judgments, and So Forth.—Deductions attributable to any claim, award, judgment, or decree against the taxpayer, or interest on any of the foregoing, if abnormal for the taxpayer, shall not be allowed, and if normal for the taxpayer, but in excess of 125 per centum of the average amount of such deductions in the four previous taxable years, shall be disallowed in an amount equal to such excess;

(I) Intangible Drilling and Development Costs.—Deductions attributable to intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, and for development costs in the case of mines, if abnormal for the taxpayer, shall not be allowed, and if normal for the taxpayer, but in excess of 125 per centum of the average amount of such deductions in the four previous taxable years, shall be disallowed in an amount equal to such excess; and

(J) Abnormal Deductions.—Under regulations prescribed by the Commissioner, with the approval of the Secretary, for the determination, for the purposes of this subparagraph, of the classification of deductions—

(i) Deductions of any class shall not be allowed if deductions of such class were abnormal for the taxpayer, and

(ii) If the class of deductions was normal for the taxpayer, but the deductions of such class were in excess of 125 per centum of the average amount of deductions of such class for the four previous taxable years, they shall be disallowed in an amount equal to such excess.

(K) Rules for Application of Subparagraphs (H), (I) and (J). For the purposes of subparagraphs (H), (I), and (J)—

(i) If the taxpayer was not in existence for four previous taxable years, then such average amount specified in such subparagraphs shall be determined for the previous taxable years it was in existence and the succeeding taxable years which begin before the beginning of the taxpayer's second taxable year under this subchapter. If the number of such succeeding years is greater than the number necessary to obtain an aggregate of four taxable years there shall be omitted so many of such succeeding years, beginning with the last, as are necessary to reduce the aggregate to four.

(ii) Deductions shall not be disallowed under such subparagraphs unless the taxpayer establishes that the abnormality or excess is not a consequence of an increase in the gross income of the taxpayer in its base period or a decrease in the amount of some other deduction in its base period, and is not a consequence of a change at any time in the type, manner of operation, size, or condition of the business engaged in by the taxpayer.

(iii) The amount of deductions of any class to be disallowed under such subparagraphs with respect to

any taxable year shall not exceed the amount by which the deductions of such class for such taxable year exceed the deductions of such class for the taxable year for which the tax under this subchapter is being computed.

SEC. 713. EXCESS PROFITS CREDIT—BASED ON INCOME.

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(f) AVERAGE BASE PERIOD NET INCOME—INCREASED EARNINGS IN LAST HALF OF BASE PERIOD.—The average base period net income determined under this subsection shall be determined as follows:

(1) By computing, for each of the taxable years of the taxpayer in its base period, the excess profits net income for such year, or the deficit in excess profits net income for such year;

(2) By computing for each half of the base period the aggregate of the excess profits net income for each of the taxable years in such half, reduced, if for one or more of such years there was a deficit in excess profits net income, by the sum of such deficits. For the purposes of such computation, if any taxable year is partly within each half of the base period there shall be allocated to the first half an amount of the excess profits net income or deficit in excess profits net income, as the case may be, for such taxable year, which bears the same ratio thereto as the number of months falling within such half bears to the entire number of months in such taxable year; and the remainder shall be allocated to the second half;

(3) If the amount ascertained under paragraph (2) for the second half is greater than the amount ascertained for the first half, by dividing the difference by two;

(4) By adding the amount ascertained under paragraph (3) to the amount ascertained under paragraph (2) for the second half of the base period;

(5) By dividing the amount found under paragraph (4) by the number of months in the second half of the base period and by multiplying the result by twelve;

(6) The amount ascertained under paragraph (5) shall be the average base period net income determined under this sub-section, except that the average base period net income determined under this subsection shall in no case be greater than the highest excess profits net income for any taxable year in the base period. For the purpose of such limitation if any taxable year is of less than twelve months, the excess profits net income for such taxable year shall be placed on an annual basis by multiplying by twelve and dividing by the number of months included in such taxable year.